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Development challenges facing island developing countries: basic issues and prospects in the context of trade liberalization and globalization

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[1] The statistical data used in the preparation of this report will be available in a separate annex document.

Introduction

1. The General Assembly, in its resolution 49/100 of 19 December 1994, invited the Commission on Sustainable Development to convene a high-level panel to discuss the challenges faced by island developing countries (IDCs), particularly in the area of external trade. It also invited the Secretary-General of UNCTAD to organize this panel. To that end, UNCTAD prepared this report which will be the main input to the panel's discussions. The report first provides an overview of the performance and problems of IDCs, particularly in the external trade sector. It then analyzes the main features of trade liberalization and globalization and their relevance for IDCs. The paper then focuses on the implications of these developments on the trade specialization prospects of IDCs. Finally, the paper draws up key policy recommendations for future action.

2. Furthermore, UNCTAD, in cooperation with the Department for Policy Coordination and Sustainable Development, undertook two studies covering the Caribbean and Pacific regions. These studies, which examine regional specific trade and development issues, will be submitted to the panel to assist it in its deliberations. The panel will also have a background document on trade issues and sustainable economic development which provides a broad spectrum of issues related to the development constraints and prospects of IDCs.

3. The focus on external trade issues, which permeates through the documentation before the panel, underscores the paramount importance of trading opportunities for sustainable economic development, considering the smallness of most IDCs domestic markets and the heavy dependence of these countries on foreign markets. These aspects are fully recognized by the Programme of Action for the Sustainable Development of Small Island Developing States (SIDS), which was adopted by the Global Conference on the Sustainable Development of SIDS in Barbados in May 1994. The Programme of Action stresses, *inter alia*, the importance of seeking expansion and more stability in export earnings through diversification in goods and services, and points to the need for a "non-discriminatory trading system" (Para. 96) if SIDS are to achieve sustained economic growth.

4. This issue paper responds to the request of the Programme of Action for a study of "the effects of trade liberalization and globalization on the sustainable development of small island developing States, including relevant recommendations" (Para. 99). Although the issues analyzed are mainly those of small island economies, the paper refers to island developing countries in general, in accordance with resolution 49/100.

I. Overview of the performance and problems of island developing countries, particularly in the external trade sector

5. IDCs are a very diverse group of countries with a wide range of geographical situations, natural resource endowments and economic capacities. These disparities are reflected in the diversity of national income levels within the group: half of the 37 island developing countries and territories with a population under one million belong to the two highest-income countries groups according to the World Bank, while nine IDCs within the same size limit are in the category of Least Developed Countries[2].

6. In spite of their diversity, most IDCs share common characteristics such as smallness (which implies a limited domestic market), remoteness (distances from large market centres), geographical dispersion, proneness to natural disasters,

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[2] Cape Verde, Comoros, Kiribati, Maldives, Samoa, Sao Tome and Principe, Solomon Islands, Tuvalu, Vanuatu

scarcity of natural resources and the risk of depletion of non-renewable resources, fragility of eco-systems, shortages of fresh water supplies, export concentration, heavy dependence on imports, transport and communications constraints, emigration of skilled nationals, shortages of skilled manpower, and a weak indigenous technological capacity. Most of these characteristics are particularly acute in small IDCs. Among all these factors, smallness and external dependence can be described as the main characteristics of island-specific vulnerability. Smallness regards either the global size of a country or the existence of small peripheral islands in an archipelagic country. External dependence is a context that refers to physical factors, such as natural disasters or global environmental trends, as well as economic factors, such as foreign market conditions (e.g., instability in prices, demand, etc.). Many implications of smallness cause the external trade structure of most IDCs to be little diversified and highly dependent on external forces, which explains the situation of economic vulnerability of these countries. This overview first highlights recent developments in the external trade sector of IDCs.

1. Trade performance of island developing countries[3]

7. During the 1985-1992 period, the average annual growth of IDCs agricultural production was slower than that of manufacturing production (2.6% and 4.1%, respectively). A higher growth performance was recorded in the field of services: wholesale and retail trade services grew by 4.7% during the 1985-1991 period, while transport and communications services recorded an annual growth rate of 6.0%. The export ratio (X/GDP) of IDCs was estimated at 31% in 1992, and the import ratio (M/GDP) at 51%. The latter figure indicates the extent of external dependence of IDCs, where a high import propensity is often observed. Yet, the average annual growth of imports of IDCs was significantly lower in the 1980-1993 period (7%) than in the 1970-1980 period (16%). The average export growth performance of IDCs was also significantly lower during the 1980s decade (4.4% in 1980-1993) than during the previous decade (16% in 1970-1980). These estimates indicate that the global trade performance of IDCs has been much less strong in recent years. This is corroborated by the indication of a decline in the terms of trade of IDCs between 1980 (index 100) and 1993 (88.5). Export instability increased during the 1980s decade, as the magnitude of fluctuations in merchandise export values augmented by 24% during that period in comparison with the 1970s decade.

8. The average dependence on the first commodity in percentage of total exports decreased significantly between 1980 (50%) and 1992 (36%). This means that the export concentration of IDCs has diminished, while the instability of export earnings remained a sign of economic vulnerability. Manufactured exports have been playing an increased role in the structure of exports of IDCs (24% in 1992 instead of 20% in 1980). Food imports account for a much smaller proportion of total imports than manufactured imports (20% and 63%, respectively). IDCs exported 73% of their merchandise to developed countries and 24% to other developing countries in 1993. Similar ratios for imports confirm the importance of North-South trade for IDCs: 70% of total imports are from developed countries, and 29% from developing countries.

9. The value of services exports was in 1992 three times larger than the value of merchandise exports, and the total inflow of export receipts from services and private transfers from abroad was nearly four times as large as the total value of merchandise exports. The importance of tourism in island economies is reflected in the average ratio of tourism earnings to total earnings from goods and services exports in 1992: 34%. While the average trade deficit of IDCs, in

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[3] Some 47 island developing countries and territories with a population under 5 million make up the sample hereby used.

percentage of GDP, was high in 1993 (-52%), the average current account deficit (-8%) reflected the mitigating impact of service receipts and private transfers. IDCs recorded a low average number of months of imports covered by international reserves in 1993 (2.8 months).

10. A comparative glance at the economic performance of IDCs and non-island developing countries (non-IDCs) reveals that IDCs demonstrated, in the last decade, a better performance than non-IDCs in terms of growth of agricultural, manufacturing and services production[4]. IDCs also recorded, in the 1980-1993 period, slightly higher trade growth than non-IDCs. However, a sharp contrast between the two categories is observed in the degree of export instability: the magnitude of fluctuations in merchandise export values increased by 24% in IDCs from the 1970s decade to the 1980s decade, while it diminished by 14% in non-IDCs. This reflects a much greater export concentration in IDCs. The instability of export receipts during the 1980s decade was greater in IDCs than in non-IDCs by 75%, whereas the gap between the two categories of countries was only 21% during the previous decade. Of significance too is the contrast between the trade deficits of IDCs and non-IDCs in percentage of GDP (-52% in IDCs; -15% in non-IDCs). In short, the external fragility of IDCs is greater than that of other developing countries within the same range of sizes, as also illustrated by the difference in the average number of months of imports covered by international reserves (2.8 in IDCs; 4.0 in non-IDCs).

11. These observations reflect a variety of island-specific characteristics that are at the root of the trade performance, external dependence and economic vulnerability of IDCs. One can classify the factors affecting the external trade performance of IDCs into factors of comparative disadvantage on the one hand, and factors of comparative advantage on the other hand.

2. Factors of comparative disadvantage of IDCs

12. The two main categories of factors of comparative disadvantage of IDCs are the handicaps of smallness and remoteness, which are usually analyzed as the intrinsic factors of trade concentration, external dependence and economic vulnerability. However, the relationship between smallness or remoteness and economic performance is not static. It has changed in recent times. In particular, the inverse causality between the lack of opportunities to find economies of scale (the overriding consequence of smallness) and the economic viability of projects has decreased as a result of success, in some IDCs, in adopting more appropriate technology and realizing small-scale investment.

2.1 *The issue of smallness*

13. As pointed above, many IDCs have a narrow natural and human resource base and a small domestic market. As a result, their economic structure is often little diversified and lacks resilience *vis-à-vis* adverse external factors (physical or economic). Concentration in the trade structure is a source of external dependence. As the external context is prone to instability (international prices/demand fluctuations), trade concentration can be a serious cause of vulnerability[5].

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[4] Some 28 non-island developing countries with a population under 5 million make up the sample considered in this comparison.

[5] In the Windward Islands of the Caribbean, the strong concentration on banana production (over 50% of merchandise exports in St. Lucia, Dominica and St. Vincent and the Grenadines) is a source of economic vulnerability, considering the uncertainty in the future of preferential market access to the European Single Market, and the risk of physical destruction due to inclement weather.

14. As smallness and the lack of diversification are common to several IDCs within a given region, intra-regional trade is unlikely to develop insofar as small island countries tend to produce the same commodities (e.g., sugar, copra, banana) and offer limited scope for intra-regional complementarity.

15. Diseconomies of scale result from the absence of a critical size, either in investment or in the production process, at the level of domestic consumption or in terms of access to an external market. Even though there is a large variety of situations in which the problem of scale and economic viability can be observed, these situations generally have in common a context of lack of competitiveness and insufficient profitability. These are often determining factors in deciding against a production project when the investment is foreseen as being uneconomical because the local market is insignificant while exporting competitively remains out of reach.

16. There are of course areas of decision-making in which scale-related handicaps have to be ignored, i.e., in which decision makers will have to accept the costs of smallness. Such areas are generally confined to the domain of public policy-making. They involve the physical or social infrastructure that is required if very small communities, particularly in peripheral islands of archipelagic countries, are to receive equitable attention. For example, the construction of a jetty or a health centre, or the renovation of school premises in an outer island with a population of a few hundreds will be envisaged regardless of their unit cost if such decisions are deemed to be vital for this population. Often, financial aid will be sought for such vital, though uneconomical projects. Smallness can therefore entail external dependence, not only in the area of trade but also in terms of the level of access to external financing.

2.2 *The issue of remoteness*

17. The issue of island remoteness is closely related to that of smallness in the case of archipelagic countries. In most situations of geographical remoteness within a given country, trade development in the peripheral islands (other than local trade resulting from subsistence activities) is even more constrained than in the main islands because of the difficulties in importing production inputs and transporting outputs either to the capital or abroad.

18. For some IDCs, remoteness within the island region adds further to the problem of the lack of inter-island complementarity in production. Even if a given product could be "complementary" enough to find a regional market, inter-island distances within the region may imply transport costs that would be disproportionate to the market value of the products. In cases of longer distances, relatively high shipping costs applied to small-scale transactions, and often in goods of limited value, can be a major obstacle to the participation of an IDC in international trade. Distance and low levels of demand for cargo loads often make island ports of call unattractive for long-haul shipping lines. Developments in containerization and bulk transport, which have changed the nature of sea transport, have led to the marginalization of small island operators.

19. The impact of the cost of island remoteness with regard to international tourism may be less negative. To many tourists, the inconvenience caused by a longer flying distance with a reasonable cost difference will often be deemed acceptable in comparison with the interest in the island destination. In most other areas of international services, the disadvantage of remoteness may also be considerably reduced as a result of the increasing use of modern telecommunications.

3. Factors of comparative advantage of IDCs

20. Like all countries, IDCs enjoy comparative advantages, although the latter are often not completely perceived and exploited. Factors of comparative advantage of IDCs include: (a) qualities based on natural resources, with environmental beauty as a determining factor of tourism development; (b) socio-political stability, which is observed in a majority of IDCs; and (c) the privileged links of IDCs with developed market countries through trade preferences for the benefit of various sectors of activity.

3.1 *Qualities based on natural resources*

21. Comparative advantages based on non-renewable resources have limitations that need to be taken into account in long-term, sustainable development planning. In the area of renewable resources, the most significant comparative advantage is often found in the size of marine resources, particularly in IDCs of the Pacific that have large exclusive economic zones.

22. Another valuable natural advantage of many IDCs is the quality of the environment, an asset which is conducive to tourism activities. Environmental diversity and beauty become particularly beneficial when they allow specialized forms of tourism, including tourism products that are based on ecological, health-related or cultural values.

23. While few large-scale natural advantages other than vast marine resources and, for some IDCs, oil or mineral resources can be identified, there are other types of advantages that are associated with smallness and remoteness. In the Caribbean, many of the highly rated luxury resorts are found on small peripheral islands of archipelagic countries or territories. In some cases, remoteness is regarded as a related attribute that enhances the quality of the product. Such comparative advantages may have significant economic implications in IDCs where environment-based industries, in particular tourism, exist or could be developed.

3.2 *Socio-political stability*

24. Over three quarters of IDCs with a population under 5 million enjoy a relatively stable political situation. With a few exceptions, the social situation has also been stable in IDCs in general. While such stability is generally desirable to allow an open economy to progress, it becomes indispensable if the specialization pattern is largely based on international services. Often, smallness and isolation contribute to a fair social and political cohesion in island societies. In the absence of major social inequalities, entrepreneurship tends to be widely accepted and economic motivation takes place. Tourism and offshore finance services would not have developed if socio-political stability was not a dominant feature in many IDCs.

3.3 *North-South relationships*

25. Factors of good governance partly explain the privileged relationship that most IDCs maintain *vis-à-vis* developed market countries in general, and former or remaining colonial powers in particular. A large part of the trade opportunities enjoyed by IDCs of the Caribbean, the Indian Ocean and the Pacific is due to the continuation of significant trade preferences for these countries (Lomé Convention, Caribbean Basin Initiative, various generalized systems of preferences from OECD countries, etc.). Availability of aid has in recent years become more closely related to the quality of governance in developing countries in general. While this trend does not exclude IDCs in principle, a paradox can be found in the lessening of eligibility to concessional aid levels that several

Caribbean countries and territories are now faced with, not because they are not well governed, but as a result of their apparent prosperity as measured by GDP-based indicators[6].

4. External dependence and economic vulnerability of IDCs

26. As a result of their specific handicaps, IDCs are intrinsically vulnerable. Vulnerability, however, connotes a degree of exposure to various risks, but does not imply that the threats underlying these risks are necessarily verified. In the absence of realization of risks, an island country might demonstrate a good economic performance. However, very few IDCs have remained undisturbed by external shocks or negative influences. External shocks, particularly those relating to international trade, represent a general threat from which virtually no IDC is likely to escape. Certain implications of trade liberalization and globalization are of critical importance in this regard.

II. RECENT DEVELOPMENTS TOWARD TRADE LIBERALIZATION AND GLOBALIZATION: IMPLICATIONS FOR IDCs

27. The outcome of the Uruguay Round of multilateral trade negotiations (UR) as well as certain regional trading arrangements have implications for IDCs.

28. **In the long run**, IDCs, like other developing countries, are expected to benefit from the global context of trade liberalization, which will bring about new trading opportunities, and from the new multilateral trade framework, which improves rules and disciplines. However, the extent to which IDCs will be able to benefit from these developments depends on the capacity of these countries to manage their transition to a situation of greater integration in the global economy.

29. **In the short run**, most IDCs are faced with a major challenge because of their structural disadvantages and their generally limited capacity to meet new trading opportunities in terms of competitiveness and reliability of supply. The tariff reductions that result from the UR and are based on the Most Favoured Nation (MFN) principle imply that the preferential margins which have been accruing to many IDCs will be eroded. This erosion factor is particularly relevant to textiles, clothing and other manufactured products. It challenges with particular acuity the IDCs which have been able to diversify and develop manufacturing activities. The challenge stems from the difficulty, for such countries, to maintain market shares in preference-giving countries as the latter are increasing competition to IDCs from third countries, including some highly competitive developing countries, by reducing the MFN tariffs facing these countries. For some IDCs, therefore, little or no benefit is likely to be gained in the short run. A few IDCs may be "net losers" as a result of losses in

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[6] This growing concern, which is mainly heard in the Caribbean region, has raised the question of constructing an indicator of economic vulnerability to complement the imperfect information provided by GDP-based measurements. The Barbados Programme of Action recommends that such indicator be developed (Para. 113 and 114).

competitiveness and slow progress in seizing trading opportunities[7]. These issues will be discussed below.

30. As of 22 February 1996, 14 IDCs with a population under 10 million were members of the World Trade Organization (WTO), out of a total membership of 119 countries[8]. As of 31 January 1996, three other IDCs had requested to join the WTO, and their applications were being considered by accession working parties[9]. Two more IDCs had the observer status[10].

31. Among island States which were neither members nor observers of the WTO or currently being considered by accession working parties as of 31 January 1996 were six Least Developed Countries[11] as well as the Federated States of Micronesia, the Marshall Islands and Nauru.

32. There are four general areas of implications for IDCs of the new multilateral trade framework: market access; non-tariff measures; the "new issues"; and systemic issues.

1. The Uruguay Round and IDCs prospects for export market access

33. Market access obligations of WTO members are based on national schedules of commitments. The outcome of the UR implies a wider geographical coverage of commitments encompassing a large number of developing countries, more open markets for goods (with a broader coverage which includes agriculture), and a higher degree of market access security as a result of the central role of tariff binding, which is estimated to cover 87% of total merchandise trade. As a result of the conclusion of the UR, tariffs will be reduced; tariff escalation, which affects processed goods, will be eliminated or reduced in various sectors; and a variety of non-tariff barriers to trade will be phased out. Overall, international trade, particularly of industrial goods, is being liberalized, even though tariff reductions in developed countries for industrial goods from

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[7] A thorough analysis of the impact of the Uruguay Round can be found in: UNCTAD, **The outcome of the Uruguay Round: an initial assessment**, Supporting Papers to the Trade and Development Report, 1994. The impact of the Uruguay Round on different island regions has also been analyzed in detail in various studies. See in particular: Davenport (M.), *Impact of Uruguay Round and NAFTA on Commonwealth Caribbean Countries, with special reference to Jamaica*, Commonwealth Secretariat, May 1995; G.S.R Associates, *Implications of Uruguay Round Agreements for CARICOM countries*, August 1995; REDMA Group, *The Uruguay Round Agreements: Implications for the CARICOM region*, Report to the CARICOM Secretariat, 1995; ESCAP, *Uruguay Round: some implications for Pacific island countries*, 7-9 November 1994; Greenaway (D.) and C. Milner, *The Uruguay Round and Commonwealth Developing Countries: An Assessment*, A Report to the Commonwealth Secretariat, February 1995.

This section does not attempt to report all findings from these studies, but focuses on the most important aspects of cross-regional interest.

[8] These countries were: Antigua and Barbuda, Barbados, Dominica, the Dominican Republic, Fiji, Grenada, Haiti, Jamaica, Maldives, Mauritius, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago.

[9] Seychelles, Tonga, Vanuatu.

[10] Papua New Guinea's protocol of acceptance of WTO obligations was approved by the General Council of WTO on 15 November 1995. The General Council has approved the schedules of the Solomon Islands, thereby agreeing that the country has fulfilled the requirements of membership and can accede to the WTO 30 days after it accepts the WTO Agreement, which it can do not later than by 31 December 1996.

[11] Cape Verde, Comoros, Kiribati, Samoa, Sao Tome and Principe and Tuvalu.

developing countries will be less significant than for goods from other developed countries. While average tariff reductions may be less than satisfactory for some product groups of particular export interest to IDCs (e.g., fish products, leather goods), there are product groups also of export interest that have recorded more than average tariff cuts[12].

34. To a large extent, products made in IDCs and exported to developed market countries are covered by preferential trading arrangements which imply low-rate or zero-rate tariffs. The main preferential trade schemes benefitting IDCs are found in the trade provisions of: the Lomé Convention between the European Union (EU) and ACP countries[13]; the Caribbean Basin Economic Recovery Act involving preferential access to the United States market for Caribbean countries, CARIBCAN between Canada and Caribbean countries, the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA) between Australia and New Zealand and Pacific island developing countries, and individual generalized systems of preferences granted by other OECD countries.

35. Many **tropical products** are of significant export interest to IDCs. It is estimated that the erosion of preferences will be small because MFN tariffs were not high for most of these products. However, the elimination of preferential access to the EU market for coffee and cocoa beans producers is likely to affect the EU market share of some IDCs[14]. EU preferences for these products as well as palm oil had helped IDCs that incur high transport costs to reduce the comparative disadvantage entailed by these costs.

36. A number of IDCs are highly dependent on exports of **bananas**[15]. In the light of the revised GATT (1994), the EU's import regime of preferences/tariff quotas for bananas from ACP countries is regarded as an unfair trade practice by non-ACP, competing producers. This import regime, which is being challenged and on which a GATT panel made an adverse decision in 1993, is due to last until 2002. The uncertainty concerning its extension beyond this date makes the remaining period particularly critical for the concerned banana-producing IDCs, which are urged by circumstances to engage into long-term economic diversification.

37. **Sugar** is of particular importance to several IDCs[16], while it competes with sugar beet, a temperate agriculture product. Under the Sugar Protocol of the Lomé Convention, the EU buys country-specific quantities from ACP countries at a fixed price which is negotiated annually. As a result of the decrease in domestic support to European beet producers, prices of beet sugar are expected to diminish in the EU, and there is a risk that the intervention price of cane

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[12] Details of tariff reduction for selected primary and processed commodities in the European Union, Japan and the United States before and after the UR can be found in: UNCTAD, *Analysis of the evolution of prices and trade of commodities to be expected in the light of the results of the Uruguay Round, with particular emphasis on their implications for developing countries, including their diversification prospects*, The Uruguay Round and international commodity trade and prices, Addendum, Statistical annex, Table 16, TD/B/CN.1/30/Add.1, 31 August 1995, pp. 23-28.

[13] 26 of the 70 ACP countries are island developing countries.

[14] examples: Sao Tome and Principe, Papua New Guinea, Solomon Islands

[15] The proportion of bananas in the structure of merchandise exports of the Windward Islands in the Caribbean was as follows in 1992: St. Lucia 61%, Dominica 58%, St. Vincent and the Grenadines 57%.

[16] particularly, Mauritius, Fiji, Barbados, Jamaica, Trinidad and Tobago

sugar which is offered to ACP countries by the EU will eventually decrease, even if quotas remain.

38. The **Agreement on Agriculture** provides for wide tariffication of existing non-tariff barriers, binding of resultant tariffs, and tariff reductions, as well as gradual phasing out of domestic support measures and export subsidies. Least Developed Countries are exempted from these requirements[17]. Some IDCs, such as Cape Verde, Comoros and several small Pacific island countries, are **net food-importing countries**. They may suffer from increases in import prices of temperate products (cereals, meat) for which protection and subsidies will decrease. It is difficult to evaluate this effect with precision, because different factors such as agricultural supply responses in the importing countries and changes in consumption patterns or importing policies should be taken into consideration. A Ministerial decision was adopted at the end of the UR in favour of these countries[18]. Compensatory measures are expected to bring responses to this issue.

39. The **Agreement on Textiles and Clothing** provides for a gradual elimination of quantitative restraints under the Multifibre Arrangements (MFAs). Few IDCs have been bound by MFAs, as most textile-producing IDCs enjoy preferential market access for textiles and clothing. The gradual loss of preferences for IDCs that export to developed countries which are called to integrate MFA quotas into the general MFN framework represents a major challenge for these exporting countries, considering the competition brought by third countries that will be able to export without MFA restrictions.

40. In the textile sector, the question of comparative advantage is of particular importance. Because of the labour-intensive nature of the sector, few small IDCs have begun or successfully pursued textile production. Textile industries are mainly found in Mauritius, Fiji and Jamaica, where manpower has not been scarce and labour costs have remained within competitive ranges given the preferential access that these countries have benefitted from[19]. Textile products from ACP countries, subject to their compliance with rules of origin, are admitted duty-free on the EU market. Caribbean products have been enjoying preferential access to the United States market under regulations whereby products manufactured from United States-made inputs can be admitted on the United States market with a customs duty based only on the value added in the exporting country.

41. Textile-producing IDCs are affected by the 10-year phasing-out period during which third countries with significant competitive advantages will gradually receive MFN treatment from importing countries. It is important, for the concerned IDCs, to take advantage of this period to adjust or reconsider their specialization in the textile sector. Adjustments should imply either significant efforts to increase competitiveness in existing textile activities, or a certain extent of re-specialization, either within the sector through

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[17] cf. UNCTAD, **The Least Developed Countries 1995 Report**, pp. 119-126.

[18] cf. **Ministerial Decision on Measures Concerning the Possible Negative Effects of the Reform Programme on Least Developed and Net Food-Importing Developing Countries, 1994.**

[19] **Preferences have been given in the following markets: Mauritius from the EU; Fiji from Australia and New Zealand; Jamaica from the EU and the United States.**

diversification into higher value-added products, or away from the sector by terminating least competitive productions[20].

42. Several Caribbean countries as well as Mauritius and Fiji have a **manufacturing** capacity with regard to such products as chemicals, consumer electronics, toys, footwear and sport equipment. Market access improvements resulting from the UR are beneficial to these countries. For IDCs that cannot specialize into products for which tariffs have diminished, the benefits are limited at present. However, export capacities may expand over time with existing enterprises improving their export potential and new enterprises being created to seize new trading opportunities. For such enterprises, the UR Agreements on non-tariff measures provide a global framework which protects them against unfair trade practices.

2. The Uruguay Round Agreements on non-tariff measures and "new issues" and their implications for IDCs

43. Multilateral disciplines on non-tariff measures have been significantly improved so that such measures will no longer be used as disguised forms of protection. IDCs exports have not been spared by non-tariff measures[21]. The Agreements on Safeguards and on Subsidies and Countervailing Measures are among the new instruments that regulate the use of non-tariff measures. Other areas in which the UR has enhanced the framework of international trade for developing countries in general and IDCs in particular include the "new issues" of services, trade-related investment measures and trade-related aspects of intellectual property rights.

44. The **Agreement on Safeguards** prohibits the use of voluntary export restraints, orderly marketing arrangements and similar measures that can affect the external trade of developing countries. It brings transparency in the procedure to be followed when safeguard measures are invoked, specifies the criteria to determine serious injury, regulates notification and consultation procedures and imposes disciplines and accountability in the use of safeguard measures. IDCs may find an advantage in the *de minimis* clause whereby a safeguard measure cannot be applied against a product from a developing country if this country's share of the total imports of the relevant product in the importing country does not exceed 3%, and when developing countries with individual import shares of less than 3% account collectively for not more than 9% of the total imports. Considering that most individual IDCs will be unlikely to often account for more than 3% in the import structure of any importing country, the risk of facing safeguard measures will be limited.

45. The **Agreement on Subsidies and Countervailing Measures** imposes disciplines in the use of subsidies and countervailing measures. Special and differential treatment is accorded to developing countries and Least Developed Countries, considering the importance of certain subsidies in the public policies of developing countries. The use of subsidies by IDCs, within authorized limits, should be guided by the consideration of trading opportunities and island-specific supply constraints. Considering the complex nature of obligations and legal and administrative implications for national implementation of the

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[20] For Caribbean countries, existing preferences vis-à-vis the United States market may be enhanced through tariff-free entry into the United States, i.e., NAFTA-parity treatment; on the EU market, ACP countries will continue to benefit from tariff-free access so long as the Lomé Convention will last.

[21] The World Bank estimated at 21% and 24% the proportions of Caribbean exports to the EU and the United States, respectively, that have been affected by non-tariff measures devised to restrict or control trade.

Agreement, many member IDCs are likely to need technical assistance in this regard.

46. The **General Agreement on Trade in Services** (GATS) offers a sound framework for this sector of great interest to IDCs. The GATS liberalizes cross-border movements of persons only at senior technical or managerial levels. This, to a large extent, meets the interests of IDCs that have a prominent service sector (tourism, information processing, offshore finance, etc.) and need expatriate expertise to raise these activities to international standards. On the other hand, IDCs that would have a comparative advantage in exporting labour services and would count on remittances from nationals working abroad could find obstacles in other member countries, as the latter are not committed by the GATS to authorize free entry of labourers.

47. Most IDCs have significant comparative advantages in certain areas of services. It is in their interest to liberalize the entry of quality services as inputs to foreign exchange-earning sectors of services. Considering the importance, for service economies, of having access to advanced technology, some IDCs have put as a condition accompanying their schedule of commitments to the GATS the possibility of benefiting from the assistance of developed countries in improving their access to technological facilities. An example relevant to the tourism sector is the access to computerized reservation systems, an area which is affected by Article IV of GATS[22].

48. The **Agreement on Trade-related Investment Measures** (TRIMs) removes a certain degree of freedom in policy-making by prohibiting measures that are sometimes used by developing countries, including IDCs, *vis-à-vis* foreign investors: local content requirements, trade balancing requirements, minimum export requirements, etc. Usually, developing countries that apply TRIMs are desirous of redistributing the benefits of hosting multinational enterprises, and countering the use of restrictive trade practices by these enterprises. In most IDCs, however, local supplies are insufficient, non-existent or unsteady. Many IDCs, particularly in the Caribbean, are already widely open to foreign investors and not inclined to impose restrictive conditions. What matters more to these countries is the prospects that foreign direct investment brings with regard to indigenous employment. In larger IDCs, however, there may be a need to protect local suppliers of goods or services, and certain TRIMs may have been designed to that end. The Agreement on TRIMs, in this regard, may impose a constraint on policy options and limit the bargaining position of host countries *vis-à-vis* foreign investors.

49. The **Agreement on Trade-related Aspects of Intellectual Property Rights** (TRIPs) sets out a national-treatment commitment and a most-favoured-nation clause with regard to the protection of individual property. It concerns all intellectual property rights and sets out the obligations of member governments to ensure that intellectual property rights can be effectively enforced by foreign right holders as well as by nationals.

50. For many IDCs, the Agreement on TRIPs implies legislative revisions but has little immediate impact on trade and development strategies. Such impact could be significant if these countries were encouraging exports of technology-intensive goods, because of the increased cost of acquiring and using technology if the protection of this technology is effectively implemented. Such costs could erode the export competitiveness of certain imitation products, particularly in the textile field where a number of IDCs have been successful. In IDCs like in other developing countries, effective implementation of intellectual property

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[22] cf. Article IV.1b of GATS: *Increasing participation of developing countries*, where "distribution channels and information networks" are cited.

rights obligations in technology transfers could be a factor adverse to industrial development by introducing a fair pricing of technology. But a positive effect could be the encouragement, for IDCs, to adopt appropriate technology in productive investment, and pay more attention to the question of the optimum size and type of equipment, a concern which may be conducive to greater efficiency and profitability and enhanced respect for the environment. Another special interest of IDCs will be the protection of their own intellectual property rights. An example can be found in the area of information processing activities, where computer software products are locally designed and need appropriate protection.

3. Systemic issue: the dispute settlement mechanism

51. Improvements in the dispute settlement mechanism and the scope for a greater participation of IDCs in the multilateral trade framework constitute an important area in which IDCs should benefit from the outcome of the UR.

52. The **Understanding on Rules and Procedures Governing the Settlement of Disputes** sets out the procedure to settle disputes that have not been settled through consultations. The new dispute settlement apparatus in the WTO comprises a Dispute Settlement Body (DSB) as well as an Appellate Body to consider issues of law covered in regular panel reports and legal interpretations developed by panels. An Appellate Body report will be adopted by the Dispute Settlement Body and unconditionally accepted by the parties within 30 days following its issuance to members, unless the DSB decides by consensus against its adoption.

53. IDCs will generally benefit from the improvement brought to the new dispute settlement system, particularly because the latter is more equitable between members with unequal bargaining powers. In the past, large countries could block the dispute settlement process more easily than any small contracting party could. However, the main problem that IDCs are facing with the new dispute settlement mechanism is their relative incapacity to cope with procedural requirements such as the various investigations and consultations implied in situations of dispute. IDCs that will be involved in dispute settlement matters will therefore need technical assistance to meet these requirements.

54. One of the major changes introduced by the WTO dispute settlement mechanism is the *negative consensus* approach. Under this approach, a consensus will no longer be needed in order to advance proceedings as was the case under the old GATT system. Instead, it will be needed in order to halt the proceedings from advancing at any stage of the formal dispute settlement procedure. This change can be regarded as an enhancement insofar as it removes the potential for blocking dispute settlement procedures. However, the effectiveness of the negative consensus principle can also be interpreted as having significant implications for developing countries, for example in the context of the challenging of trade preferences. In a situation of dispute settlement where the final decision would be favourable to the members which challenge the preferences enjoyed by IDCs, the probability of the DSB deciding *by consensus* against the adoption of the adverse report would be near to zero. In this framework, small IDCs with a highly concentrated export structure and an export performance dependent on preferences could lose their last chance of attracting an exceptional or differential treatment[23].

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[23] Windward Island countries of the Caribbean have expressed this concern with regard to the challenging of the European Union's banana import regime and preferences in favour of ACP countries.

4. Competition policy in the context of trade liberalization

55. Enterprises, in island developing countries (IDCs), are often faced with a lack of opportunities to benefit from economies of scale. Many small enterprises would not have been able to remain profitable without the protection of tariffs or quantitative restrictions. Moreover, in small island societies, the temptation to protect may stem from links of kinship between policy makers and entrepreneurs. However, protecting small producers to allow competition to be confined to domestic suppliers would defeat the objective of liberalizing international trade.

56. It may then be in the interest of IDCs to facilitate the development of less fragmented, open economies with small numbers of efficient, larger enterprises. The question is how to maintain a sufficient degree of competition between such entities without sacrificing the gains from economies of scale and efficiency. Given the influence of globalization factors, it may be advisable to encourage competition to a domestic island market. Competing viably on such a market will not depend on scale factors only. Other factors that can enhance the chances of incoming enterprises include the possible superiority of a new type of competing product; the inherent value of a well recognized brand that is new to the country; an improved technology; or improved distribution methods, which can also be enhanced by increased competition. Such factors can put a positive pressure on incumbent firms in an island country and increase the efficiency of these firms and their capacity to become competitive exporters as well.

57. IDCs governments should facilitate the emergence of competitive enterprises, which are likely to raise quality standards while at the same time trimming price levels. This implies providing appropriate information on investment opportunities and appropriate local facilities for prospective foreign investors. Foreign direct investment as well as mergers or takeovers by foreign firms can bring about desirable results. Such developments, however, should be subject to competition policy if governments want to ensure that no individual actor on the market will enjoy excessive market power that would distort competition. Appropriate competition policy should therefore be devised, including the adoption of competition legislation and the establishment under such law of a Competition Authority responsible for monitoring the implementation of the law and advising the government on competition policy matters. The competition law should also include provisions for preventing anti-competitive mergers and acquisitions.

58. Exclusive dealers and sole importers are also commonplace in IDCs for many categories of goods such as vehicles, electronics and intermediate inputs that are used in the local production of goods or services. A lack of competition at the importing level may entail higher prices and restricted choices, and will not necessarily guarantee a better quality of the output. In a closed economy, collusion among producers or traders may stifle competition and result into higher prices for customers. Here again, the role of the Competition Authority in ensuring that competition is promoted throughout the domestic economy will have beneficial results.

59. There may be situations in which small enterprises, in IDCs, would temporarily need some protection in order to remain competitive, considering their importance for employment, regional development or other socio-economic factors. Competition policies, while reflecting the above concerns, should provide for sufficient flexibility with respect to industries that cannot withstand foreign competition in the context of globalization. Trade policies should therefore integrate developmental aspects.

5. Regional trading arrangements

60. The context of trade liberalization, for IDCs, does not only stem from the conclusion of the Uruguay Round. Trade liberalization requirements have been part of individual countries structural adjustment programmes since the 1980 decade, particularly in the Caribbean. At the regional level, the evolution of the CARICOM institution has also taken place in a liberalizing environment. The CARICOM presently aims at the creation of a Single Market and Economy, involving free (or unrestricted) movements of goods, services, capital and labour with a view to encouraging competitive production of goods and services. The context of regional trade liberalization, in the Caribbean, is also affected in the longer run by the recent creation of the Association of Caribbean States (although the latter does not provide a formal framework for trade integration), as well as the project to form a Free Trade Agreement of the Americas (FTAA) by 2005. The existence of NAFTA may affect Caribbean trade in another way, through the threat of trade and investment diversion away from the Caribbean and for the benefit of Mexico, which is in a situation of free trade and free movement of capital and persons *vis-à-vis* Canada and the United States[24].

61. In the South Pacific, there are significant constraints on regional trade integration because of the lack of complementarities between partner countries, while development policies aim at stimulating trade and investment at a broader level, particularly through closer economic links with the wider Asia-Pacific region. Such links are expected, in turn, to increase trade within the South Pacific region[25].

62. In the context of trade liberalization, preferential arrangements under the Lomé Convention that are of export interest to ACP island countries should be continued, particularly for bananas, sugar and rum.

III. IMPACT OF TRADE LIBERALIZATION AND GLOBALIZATION ON THE SPECIALIZATION PROSPECTS OF IDCs

63. The globalization trend in the world economy can be defined as a movement of greater integration of national economies in the spheres of trade, investment and finance[26]. Trade liberalization, which involves movements of goods, capital and persons, is closely linked to the globalization trend as the latter implies reduced barriers to trade and wider competition, lesser obstacles to foreign investment and movements of persons, and a more transparent framework of rules and disciplines. These conditions, which are to a large extent created by the outcome of the UR, are essential to allow transactions in the global economy to be effective.

64. However, globalization is not likely to be achieved through the integration of all national economies or all regions. Certain categories of countries do not have a sufficient resource base or infrastructure to find a sizeable slot in the globalizing economy. Generally speaking, poor countries and

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[24] For details on the current situation of Caribbean trade integration, see: *Trade issues and development prospects of island developing countries of the Caribbean*, Report to UNCTAD, by D. Pantin, February 1996.

[25] For details on regional cooperation in the South Pacific, see: *Trade issues and development prospects of island developing countries of the Pacific*, Report to UNCTAD, by P. Osborne, February 1996.

[26] cf. UNCTAD, *Report of the Secretary-General of UNCTAD to the Ninth Session of the Conference*, TD/366, 2 January 1996, p. 10.

small developing countries face the risk of remaining relatively marginalized from global trends.

1. Globalization and IDCs trade in goods and services

65. IDCs present a fairly wide range of degrees of integration in the globalizing economy, from total marginalization in the case of the most remote Pacific States, to new forms of involvement in the global sphere through advanced service sectors in certain territories of the Caribbean, the Pacific and the Indian Ocean. While IDCs have generally no impact on the world economy because of their small size, some IDCs could derive "spin-off" benefits from certain effects of globalization.

66. In the global economy, IDCs generally aim at developing a production capacity and a variety of inputs to meet the expectations of foreign partners. However, considering the difficulty to develop a "carrying" capacity, in an island environment, it is not surprising that many IDCs do not necessarily expect to become really integrated in the global economy. These countries are often more tempted to pursue the opposite "niche" market approach, as they expect the latter to offer economic opportunities of a more accessible nature.

67. Three driving forces in the globalization process are relevant to IDCs and can be examined accordingly: foreign direct investment; global communications facilities; and the new multilateral framework of trade liberalization.

1.1 *Foreign direct investment*

68. Successful sectoral developments, in IDCs, have often resulted from well absorbed foreign direct investment. The absorption capacity of a host country is carefully considered by any investor who pertains to the global economy. A "global" investor is an economic actor whose investment decision is made in accordance with a global strategy which presumably involves his simultaneous presence and intervention in several countries or regions. His production, marketing and finance functions are likely to be coordinated at a multi-national (or "global") level. Deciding to invest in a small island country will probably take place only if a situation of competitive advantage has been identified in the islands. Such advantage, given the characteristics of IDCs, will be judged on the following main criteria: the geographical situation of the country (its proximity to large markets or major shipping or air routes), the natural environment (for investment in tourism), socio-political stability (an essential condition to attract any foreign investor), the presence of a qualified labour force oriented toward service activities (for offshore finance, information processing, etc.), the presence of a minimum diversity and quality of domestic producer services, and the existence of a reliable communications infrastructure (a cross-sectoral condition to attract foreign investment). Another determining factor of the decision to invest will be the participation of the host country in global trade and investment liberalization, particularly its commitments under the Agreement on TRIMS (unconstrained openness to investors), the Agreement on TRIPs (protection of the investor's industrial/intellectual rights) and the General Agreement on Trade in Services (cross-border transactions, commercial presence, movements of persons).

69. Foreign investors, in theory, are sensitive to the competitive position of a host country in terms of labour costs. Comparative studies of labour costs have shown that, while a few of the larger IDCs (such as Haiti, the Dominican Republic, Mauritius) have demonstrated cost competitiveness, a growing number of IDCs of smaller size may not have this advantage. However, the labour cost factor, in foreign investment cases that involve IDCs, has become less determinant than other factors of competitive advantage relating to skills,

stability, reliability of supplies, etc. Patterns of investment incentives are also an important factor of investment decisions[27].

1.2 *Global communications facilities*

70. The efficiency of operations and transactions in the global economy is largely facilitated by the growing integration of communications facilities, which constitutes an important facet of the globalization trend and can contribute to reduce the marginalization of developing countries. Countries such as IDCs that suffer from problems of remoteness and high transport costs could expand their export opportunities if they were able to have access to major international maritime and air routes. Not all IDCs, however, are likely to deal, currently and in the future, with sufficiently large volumes of merchandise trade to be able to justify large investment in transport infrastructure for an enhanced integration in global transport networks.

71. A sector for which access to global communications facilities and information networks is very important is that of services. State-of-the-art telecommunications facilities are essential for IDCs that are involved in international tourism, information processing or offshore finance services. Enterprises of small or medium size in these countries can broaden their markets by using information networks that will allow them to disseminate information on their goods and services[28]. In particular, remote, low-income IDCs may find in "electronic commerce" facilities such as those offered by UNCTAD's Global Trade Point Network cost-effective instruments for rationalizing their product specialization and enhancing their marketing possibilities[29]. The globalization of communications facilities, with the possibility of extending them to the smallest and most remote IDCs, therefore serves a double purpose: (a) it can enhance the business environment of IDCs, thereby making these countries, *ceteris paribus*, more attractive to foreign investors in "global" industries such as tourism or offshore finance; and (b) it can also, under an opposite angle, increase the chances of IDCs to succeed in micro-initiatives such as "niche" export projects, which do not generally pertain to the "global" sphere, but often provide small IDCs with valuable economic opportunities. The reasons for IDCs preferences for either "global" or "niche" economic activities will be discussed below.

1.3 *The new multilateral trade framework*

72. Trade liberalization is now organized under the WTO framework, which aims at reducing the obstacles to trade in goods and services in an equitably regulated and disciplined manner. The increased international competition which will result from this framework will facilitate the globalization trend[30]. IDCs should benefit from the comprehensive scope of the UR, as the latter has addressed, beside tariff and non-tariff obstacles to trade, issues that are critical to island economies, namely, trade in services, trade-related investment

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[27] However, a decrease in the relative importance of this factor will be noted in Section 3 (Para. 76).

[28] cf. UNCTAD (1996), op. cit., p. 10.

[29] Cape Verde and Sao Tome and Principe are among developing countries engaged in developing a Trade Point.

[30] "Globalization is the product of liberalization": UNCTAD (1996), op. cit., p. 11.

measures and trade-related aspects of intellectual property rights. As a large majority of IDCs will eventually be members of WTO, trade liberalization should in the long run facilitate a better integration of these countries in the global economy. However, the transition to this integration is anticipated to be difficult for some countries, and will necessitate for all IDCs an appropriate economic development strategy.

2. Globalization and micro-initiatives in the specialization of IDCs

73. In the context of trade liberalization and globalization, trading opportunities are expected to arise for the benefit of all national economies. Yet, it is anticipated that the most disadvantaged countries will face difficulties in identifying these opportunities, and in taking advantage of them. The risk of marginalization exists for developing countries that have little or no capacity to create an enabling environment for new or enhanced specialization. In their geographical and economic diversity, IDCs are confronted by this problem. Some among the most disadvantaged IDCs demonstrate little ability to diversify or only maintain their specialization in tradeable goods or services. On the other hand, there are IDCs that have already developed viable trading activities and are equipped to diversify their economy in the light of new trading opportunities. By and large, the issue of specialization, for IDCs, rests in the choice between two apparently opposite approaches: (a) on the one hand, activities implying a direct relationship with foreign economic actors who partake of the "global" economy; (b) on the other hand, micro-initiatives involving island-specific goods or services with a unique nature, and generally a trade relationship with very few partners. The latter approach, which does not involve wide competition on foreign markets, is commonly referred to as the "niche" market approach, and its characteristics are somewhat opposite to those of "globally" induced activities.

74. It is generally assumed that most IDCs have little scope for viable specialization in "global" competitive activities. Moreover, many "globally" generated activities based on productive investment in merchandise trade may have undesirable environmental implications and may conflict with the objective of sustainable development. Meanwhile, "niche" export opportunities may be difficult to identify and have a limited impact in terms of domestic employment and foreign exchange earnings. The issue is to establish, in spite of these limitations, which approach is the most desirable for IDCs, and whether some progress can be made on both sides. Evidence from the experience of IDCs shows that: (a) there are merits in the two approaches; (b) the respective merits closely relate to the size, development level and degree of external openness of the countries; and (c) the two approaches are not incompatible and can reinforce each other and create a pattern of sustainable economic development.

2.1 *Globally induced specialization*

75. The legitimate interest that many IDCs have in globally related specialization can be generated by their perception of relevant comparative advantages and fostered by their desire to avoid marginalization from the global economy. Sometimes, the perception of a comparative advantage may be an illusion if the required business environment, which should be part of the country's advantage, does not actually exist to attract outside partners. The thrust toward free-zone industrialization in countries such as the Dominican Republic and Mauritius took place at times when the debate on "global" factors was less prominent, but a "global intuition" was already present among policy makers. These countries provide examples of situations in which attracting foreign

investors to compete in global markets such as textiles and clothing has been regarded as the avenue to diversification away from dominant crops[31].

76. The conditions for successful specialization in "globally" related activities can be summarized as follows: an adequate physical infrastructure, including for international transport; the existence of a sufficient base of producer and professional services; a climate of socio-political stability; and sufficient openness to foreign investors in the trade-related investment regime. It has often been pointed out that the two factors that could in theory be regarded as *sine qua non* conditions for attracting foreign direct investment, namely, labour cost competitiveness and investment incentives, are often outweighed by the previously cited conditions. Labour costs, while remaining an important component of profitability for investors in IDCs, are less critically important for service sectors, where the largest proportion of investment now takes place. Investment incentives, including the rationalization of authorization and incorporation procedures, remain essential in IDCs like in other developing countries, but their generalization among competing countries has diminished their relative significance: if an IDC, in a given region, offers the same incentives as its neighbours do, its determining competitive advantage over the latter will have to be found among other factors (particularly, among qualitative factors) if that country is seeking a competitive edge in attracting foreign investors.

2.2 *"Niche"-type specialization*

77. Many of the intrinsic characteristics of IDCs impose severe constraints on the range of possibilities for viable economic specialization. In a situation of "small islandness", where advantages from economies of scale are difficult to find in production, marketing or transport, the context of globalization may remain a foreign phenomenon, and island regions could become pockets of marginalization. Many IDCs, however, retain chances to succeed through other development patterns that better match their intrinsic disadvantages.

78. There is a scope for micro-development experiences based on small-scale projects involving small inputs, small outputs and generally small market outlet , all of these remaining within sustainable development standards. Such projects, which can apply to merchandise trade as well as trade in services, are often referred to as pertaining to the "niche" market approach, which essentially involves a certain degree of uniqueness in the product and an exclusive or narrowly distributed marketing arrangement. Under the latter, a single producer or a small number of producers in the island country will export to a narrow market in which the importer will carry out the marketing and distribution functions, as such functions could not be efficiently fulfilled by the island producer considering the latter's small size. Often, the chances of success of a "niche" market venture rest on the ability of the island's foreign partner to transfer to the island-based producer his technology and know-how. Equally important to the success of the operation will be the importer's intimate knowledge of his "captive" market, in which he will be able to promote and distribute the goods or services efficiently.

79. The interest of IDCs in the "niche" market approach essentially stems from the awareness, among island entrepreneurs, of the "unique" nature of many island-specific goods and services. In particular, this approach can provide viable trading opportunities for nature-based ("green") products or environment-based services, to which island features of unspoiled nature and environmental

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[31] The Meade Report on *The economic and social structure of Mauritius*, in 1960, paved the road for successful economic development, as has been observed in that country in recent years.

beauty are generally conducive. As this definition reveals, the "niche" market approach is apparently opposite to the "globally" induced approach to specialization. That is mainly because of differences in the numbers of economic actors involved and in the size of markets ("global", as opposed to "captive"). In spite of such differences, it must be recognized that both approaches, if applied to an IDC, commonly involve a degree of external dependence, either on foreign direct investors, or at least on foreign partners that are likely to control the market.

80. These clear-cut concepts depict a duality of situations in which not all IDCs can be recognized. It is therefore important to point out the inter-relations and complementarities that can take place between the two approaches.

2.3 *Globalization and "niche" markets: a two-pronged approach to specialization*

81. Few IDCs provide pure examples of either "globally" induced specialization or "niche" trade activities. On the other hand, there are many cases of island economic activities that stand close to one of the two models while actually drawing on both in a viable manner.

82. Certain activities may demonstrate a high degree of specialization and display features of product and/or market "uniqueness" that delineate a situation of the "niche" type. Among such activities, one finds specialized forms of tourism involving --always on a small scale-- water sports, medical or cultural features, or eco-tourism activities offered by service suppliers that have neither the capacity nor the desire of accommodating a wide foreign demand, and concentrate their promotional efforts on small market segments. One often finds, in these sectors, that the context in which the specialization has developed, and sometimes the way in which it is operated relate to "global" factors, and in particular, have been induced by a "global" demand. In an Eastern Caribbean tourism destination more richly endowed with an exotic flora and fauna than with traditional beach attractions, unique ecological features have been developed as part of "tourist packages" twinned with neighbouring islands which respond to a more traditional tourist demand. The nature island thus benefits at the same time from its own eco-tourism activities, which involve product uniqueness, and from a neighbouring market which is representative of the global tourist demand. The "green" island therefore receives indirect benefits from a segment of the global demand, as the primary destination of these tourists is the neighbouring island, not the nature island. In other types of activities, a common scenario will be that of a "niche" sector which has developed as a result of micro-initiatives following business ideas that originally arose from successful, "globally" competitive activities.

83. Conversely, certain economic activities may pertain to widely competitive sectors and be apparent participants in "global" trade while the products demonstrate a measure of uniqueness in relation to an island feature. The latter can be incorporated in indigenous material or goods or services of a cultural nature. By giving an exotic dimension to a product that should otherwise be normally competitive by "global" standards, an IDC can enhance its chances of diversification. This approach would provide, for example, a model for enhancing a clothing industry in an exotic IDC that has been benefiting from trade preferences and is now faced with the problem of adjusting to the global liberalization of the textiles and clothing sector and consequent erosion of preferences.

84. In many IDCs, the two opposite approaches could be reconciled, as they can reinforce each other. Success *vis-à-vis* global competition may take place in island economies that have been able to create, despite handicaps, an enabling domestic environment (infrastructure, skilled human resources, producer services, etc.). Such conditions can in turn enhance the chances of success of "niche"

market activities, which often derive, as explained above, from initiatives that draw on competitive experience. Circumstances could also be met whereby a viable "niche" trade relationship involving a pioneer IDC and a narrow export market could develop successfully through a widening of this market base and the emergence of some inter-country competition. The broadening demand could in turn encourage an expansion of the production base, both in the pioneer IDC and elsewhere, particularly in neighbouring island countries as the latter would easily lend themselves to an imitation effect. The initial "niche" relationship, in this scenario, would be taken over by "global" producers and traders. Although few examples of this type of evolution have been observed among IDCs, one foresees a field of opportunities in the area of "green" products in the context of the widening trend of "green consumerism", in view of the ecological qualities of many IDCs.

3. General remarks related to sectoral specialization

85. Overall, the following general remarks can be made about the question of the potential of IDCs to achieve successful specialization or re-specialization in the context of globalization.

86. Considering the high degree of trade concentration in several IDCs that are still dominated by agriculture, viable re-specialization implies diversification within the commodity sector first, and secondarily toward other activities. Particular attention should be given to vertical diversification involving higher value-added products based on existing commodities, and to products that meet the "green" demand.

87. IDCs which have developed an industrial base and have benefited from preferential market access are facing a major challenge which urges them to strengthen their competitiveness in current activities --a difficult objective for the most disadvantaged among these countries-- and organize their product diversification in the light of new trading opportunities and comparative advantages.

88. The widest scope for viable specialization or re-specialization in IDCs rests on the development of international services, a field of activities which is being encouraged by the new WTO framework and in which there is space for initiatives under which island economies can find a path to economic sustainability. A large proportion of the scope for services lies in specialized tourism, offshore finance, information processing, and a variety of micro-activities based on island-specific features and advantages.

89. For all IDCs, however, successful specialization or re-specialization implies the adoption of a development strategy that will adequately address the specific problems of "islandness", recognize and exploit all possible comparative advantages, and take into consideration the constraint of environmentally sustainable development in the efforts to raise the economic structures to higher levels of prosperity.

IV. CONCLUSIONS AND RECOMMENDATIONS

90. IDCs which are or will become members of the World Trade Organization should in the long run benefit from increased trading opportunities and the improvement of rules and disciplines in the new multilateral trade framework. The latter is expected to provide these countries with greater and more predictable market access for many export products. In this sense, the new environment which results from the context of trade liberalization and globalization affects island developing economies in the same way as it affects other open developing economies.

91. As a consequence of their specific disadvantages and intrinsic vulnerability, IDCs face particular challenges **in the short run**. There are limitations to these countries capacity to fully benefit from new trading opportunities because of the structural handicaps inherent in the economies of these countries. Many IDCs have a limited capacity to diversify their production and export base into activities with a higher value-added. The "phenomenon of marginalization" is analyzed by the Report of the Secretary-General of UNCTAD to UNCTAD IX as arising from a variety of structural factors among which many problems of IDCs can be recognized[32].

92. Among the factors of marginalization that are observed in IDCs are supply-side constraints such as the weakness of the technological capacity; the lack of entrepreneurial skills; and the lack of finance availability for small farmers and small-scale enterprises. The Report of the Secretary-General of UNCTAD also stresses the negative impact of commodity dependence, "a major constraint on the ability of many developing countries to take advantage of trading opportunities...", and points to structural impediments to attracting foreign direct investment: the scarcity of domestic savings, which reduces the scope for joint ventures, and the low level of productivity, which is partly due to the lack of adequate infrastructure.

93. IDCs are faced with many of the challenges that liberalization and globalization impose on the process of sustainable economic development. It is in the interest of these countries to endorse the global strategy proposed by the Secretary-General of UNCTAD for promoting international trade and enterprise development as related factors of economic development. Like many developing countries, IDCs are faced with the double challenge of alleviating the costs of their transition to the global economy, and seizing new trading opportunities. This "cost/benefit" challenge, however, can only be coped with in the light of the particular implications of islandness for trade development. As demonstrated earlier, IDCs could reconcile prospects for specialization in close connection with the global economy (the "global" approach) with prospects for specialization in small-scale, "niche" activities. The latter can even be enhanced by a proximity to the "global" sphere.

94. Following are some elements of a strategy for the sustainable economic development of IDCs in general, considering the risk of marginalization faced by many of these countries in the context of liberalization and globalization. As the main problem of island vulnerability relates to the situation of external dependence, which is common to all IDCs, the immediate objective is to strengthen the trade structure of these economies: sustainable economic development implies viable diversification to increase the resilience of the economy to physical and economic shocks, considering that, in a situation of narrow specialization and export concentration, such shocks can have severe effects. In order to achieve the objective of sustainable economic development, IDCs should give priority consideration to the following areas of action, in cooperation with their development partners.

. <u>Alleviate the handicaps of islandness</u>

95. IDCs should pursue their efforts to realize the investment necessary to overcome the physical handicaps which hinder competitiveness in production, marketing and transport and can be determinant factors of marginalization from the global economy. In this respect, particular attention should be given to the facilitation of transfers of appropriate technology with a view to enabling recipient countries to adapt to changing market conditions (including environment-related standards imposed from outside) and compete effectively. This

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[32] cf. UNCTAD (1996), op. cit., p. 25.

involves, *inter alia*, (a) allowing IDCs to have access to optimal size equipment in a flexible manner and thereby reduce the problem of the lack of opportunities to benefit from economies of scale; and (b) make investment compatible with the domestic goal of environmentally sustainable development. The areas of investment considered here include international and domestic transport infrastructure and equipment and appropriate telecommunications equipment, and involve the development of a capacity to identify cost-effective, "optimum" size in public sector investment as well as productive investment. This objective implies strengthening the institutional and technical capacity to monitor technological developments and assess their relevance to island situations. Of equal importance, in this connection, will be the development of a variety of specialized domestic services (engineering, maintenance, repair, etc.), which may partly require the presence of expatriate personnel.

96. Particular attention should be given to the interest in promoting cooperative transport and communications arrangements, for example, through regional initiatives such as regional ports with facilities for transshipment of containers and other cargoes from trunk shipping routes to smaller islands, and regional ship repair arrangements.

. Promote appropriate macroeconomic and trade policies

97. Sound macroeconomic management is essential for creating or maintaining an environment of competitiveness, stability, predictability and business confidence. Competitiveness should be facilitated by realistic exchange rate policies. Economic policies should also encourage an efficient allocation of production factors in the light of trading opportunities. The latter would be enhanced by the application of appropriate competition policies, including the implementation of national competition laws.

98. The larger IDCs should seek to promote integrated production structures based on strengthened backward and forward linkages in order to reduce external dependence in certain areas such as food imports. The scope for deriving trading opportunities from the new multilateral trade framework, however limited it may be for many IDCs, should be fully exploited. In this connection, technical assistance should be provided to the IDCs which have not moved to accede to the World Trade Organization or are only in the process of accession. Assistance should also facilitate implementation by member IDCs of their legislative and regulatory obligations at the national level.

. Develop human resources in all areas relating to external trade and enterprise development

99. Considering the scarcity of skilled human resources in many IDCs, training opportunities directly or indirectly relating to trade development and entrepreneurship should be sought in order to enhance the capacity of the countries to manage their transition to a situation of greater integration in the global economy, and to take advantage of the new trading opportunities. In IDCs where entrepreneurship is limited, human resource development and sensitization to enterprise development is of critical importance. For many IDCs where skilled occupations cannot adequately be held by local manpower, the GATS provisions liberalizing movements of persons at technical and managerial levels are beneficial.

. Enhance the use of current trading opportunities

100. The capacity of IDCs to better exploit existing trade preferences should be strengthened. In spite of the erosion of preferential margins, the generalized system of preferences (GSP) is expected to continue to play a significant role in facilitating the participation of IDCs in international trade. Awareness of GSP schemes, which are major determinants of trading opportunities, is essential

if IDCs want to build export strategies. At the international level, rules of origin criteria should be flexibly defined for the most poorly endowed IDCs; accept relatively higher proportions of third-country inputs in the manufacturing of export goods; and provide for simple administration of documentary and shipment requirements. Other measures to enhance the effectiveness of GSP schemes should include the extension of product coverage to more goods of export interest to IDCs (e.g., tropical products, leather goods, textiles and clothing) and the harmonization of GSP rules of origin among preference-giving countries.

. Take advantage of new trading opportunities

101. An essential area of action, for IDCs, is to develop their capacity to identify new trading opportunities through systematic analysis, at the national level, of the implications of changes in market access for their exports, considering the existing patterns of trade and the potential for diversification. The development of trade information capacities through global communications facilities should be actively pursued. In order to stimulate responses from producers, sensitization and training efforts should be intensified and highlight the changes that have taken place with respect to tariff and non-tariff measures, quality standards and systemic procedures. Awareness programmes on new trading opportunities should be organized at national and regional levels. Particular attention should be given to the implications of "green consumerism" and related trading opportunities, non-tariff obstacles to "green" trade, and the scope for diversification into environment-based activities. Generally, more technical assistance will need to be devoted to the identification of new trading opportunities and dissemination of findings.

102. Awareness of the new rights and obligations of IDC members of WTO is also essential, and will imply continued technical assistance to facilitate the implementation of market access commitments and enable IDCs to implement legislative and regulatory changes with regard to non-tariff policies and new issues (TRIMs and TRIPs, in particular).

Create an enabling environment for trade-related foreign investment

103. Taking advantage of new trading opportunities, in most IDCs, will often imply either foreign direct investment or operational links with foreign partners under marketing, technology transfers or franchising arrangements. Many IDCs should envisage a strategic review of their business climate, assess the important factors of attractiveness from the viewpoint of foreign investors, and integrate in their development strategy the thrust to create an "enabling environment": infrastructure, competitiveness of production factors, investment incentives, producer services, etc.

. Strengthen regional cooperation for trade development

104. While all IDC regions would not support with the same strength the idea of seeking a complete regional trade integration or the creation of free trade zones, it is broadly recognized that functional cooperation at the regional level is necessary in areas where most countries would be too small to achieve efficiency. Intensification of the tasks undertaken for the benefit of IDCs traders by organizations such as the CARICOM Export Development Agency, the Eastern Caribbean States Export Development Agency or the South Pacific Forum Secretariat should be envisaged or pursued with a view to enhancing the capacity of the relevant countries to maximise the realization of trading opportunities and minimize transition costs in the context of trade liberalization.

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High-level Panel Meeting on Island
Developing Countries
22-23 April 1996

REPORT OF THE HIGH-LEVEL PANEL MEETING ON ISLAND DEVELOPING COUNTRIES

INTRODUCTION

1. The General Assembly, in its resolution 49/100 of 19 December 1994, invited the Commission on Sustainable Development to convene a high-level panel to discuss the challenges faced by island developing countries, particularly in the area of external trade, and invited the Secretary-General of the United Nations Conference on Trade and Development (UNCTAD) to organize such a panel. The documentation prepared for the Panel and the discussion that took place during its meeting also responded to the recommendation made in paragraph 99 of the Programme of Action adopted at the Global Conference for the Sustainable Development of Small Island Developing States (see A/CONF.167/9, chap. I, resolution 1, annex II) that "a study should be undertaken on the effects of trade liberalization and globalization on the sustainable development of small island developing States".

2. The High-level Panel Meeting on Island Developing Countries was held at United Nations Headquarters in New York on 22 and 23 April 1996. At the request of the Panel, Hon. Rundheersing Bheenick (Minister of Finance of Mauritius) served as Chairman of the panel. Ambassador Eugene Pursoo (Grenada) was elected Vice-Chairman-cum-Rapporteur. The present report gives a brief account of the proceedings, including the main issues presented in the documentation that were noted and agreed on by the Panel.

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I. OVERVIEW OF THE ECONOMIC PERFORMANCE AND BASIC CHARACTERISTICS OF ISLAND DEVELOPING COUNTRIES

A. Economic performance, particularly in the external trade sector

3. In 1993, the average per capita gross national product (GNP) of the 37 island developing countries with a population under 1 million was US$ 4,389, as compared to about US$ 984 for all developing countries. During 1983-1993, the average annual growth rate of GNP was about 3.8 per cent in the island developing countries; in per capita terms, the rate was 2.2 per cent. The relatively high GNP per capita growth rates in the island developing countries are in many cases related to a very low population growth rate, which reflects high rates of emigration of nationals to work in other countries. Furthermore, although most island developing countries experienced relatively favourable growth rates over the 1980s as a whole, they also experienced significant year-to-year volatility of economic growth, particularly in Pacific island economies and to some extent in the Caribbean countries. Such volatility is often associated with proneness to major economic shocks of all kinds, including natural disasters. These trends in economic growth should, however, be seen in a broader context in that GNP growth rates are not the only criteria for measuring the sustainability of development in island developing countries.

4. Available data indicate that during the 1980s, the external sector performance of island developing countries with a population under 5 million was slightly better than that of non-island developing countries with the same population (4.4 per cent for exports and 7 per cent for imports for island developing countries, 3.6 per cent and 4.3 per cent for non-island developing countries). A significant feature of the external sector trends in island developing countries, however, is the degree of export instability. During 1970-1980, export instability in island developing countries increased by 25 per cent, while in non-island developing countries it diminished by 14.5 per cent. Such instability reflects frequent fluctuations in international prices and the demand for certain traditional exports, as well as the destructive impact of natural disasters. The limited range of export commodities available in island developing countries is an added compounding factor that perpetuates such instability.

5. The export performance of individual island developing countries, however, varies considerably. The smallest and most remote countries, which are mainly located in the Pacific, do not have any significant domestic resources to propel export growth. They are heavily dependent on external rental income (trust funds, royalties from fishing rights, income from foreign military installations etc.). On the other end of the spectrum are a few countries - usually the larger ones - that have been more successful in diversifying their economies by developing export manufacturing, such as the Dominican Republic, Jamaica, Haiti, Trinidad and Tobago, Mauritius and Cyprus. Export growth in such countries has also been boosted by service exports, particularly tourism and financial services, as well as by the export of a few primary commodities.

B. Basic characteristics of island developing countries

6. Although the island developing countries are a very diverse group of countries with a wide range of geographical situations, natural resource endowments and economic capacities, all are in varying degrees subjected to a range of handicaps arising from the interplay of such factors as small size; remoteness; geographical dispersion; vulnerability to natural disasters; fragility of ecosystems; constraints on transport and communications; great distances from market centres; a highly limited internal market; lack of natural resources; weak indigenous technological capacity; acute difficulties in obtaining freshwater supplies; heavy dependence on imports and a small number of commodities; depletion of non-renewable resources; migration, particularly of highly skilled personnel; shortage of administrative personnel; and heavy financial burdens.

7. Most of the above-mentioned factors are particularly acute in small island developing countries with a narrow natural and human resource base and a small domestic market. In 1993, some 42 island developing countries had a population of less than 1 million. As to land area, 41 countries had land areas of less than 20,000 square kilometres and 33 countries areas of less than 1,000 square kilometres. Due to their small size, the economic structure of many such island developing countries is not very diversified; combined with heavy dependence on a few export commodities, this makes many of them vulnerable to instability arising from external economic shocks and international price/demand fluctuations, a major problem for their economies.

8. Their limited economic size also means that small island developing countries have reduced opportunities to take advantage of economies of scale, which tends to lead to high unit costs; small island developing countries, therefore, must devote a large proportion of their scarce financial and human resources to providing basic infrastructure and services. Archipelagic island developing countries also suffer from particular diseconomies of scale, since infrastructure must be duplicated on each inhabited island.

9. With respect to remoteness, most small island developing countries are 200 to 1,000 kilometres (km) from the nearest continent. They need to be self-sufficient in their infrastructure, such as ports and airports; by contrast, in a small continental country such services may be available in a neighbouring country and accessible by road. The islands of the Caribbean are separated from a market of more than 500,000 people by an average distance of 700 km, those of the West Indian Ocean by 1,800 km, and those of the central and western Pacific by nearly 3,000 km. The small island developing countries of the Indian and Pacific oceans are particularly remote from the land masses that are their trading partners, their migrant destinations and their sources of tourism. As a result, the costs of imported goods are particularly high, and high freight rates also militate against the competitiveness of exports.

10. The impact of the cost of island remoteness on international tourism, however, may be less negative. For many tourists, the inconvenience caused by a longer flying distance with a reasonable cost difference will often be deemed acceptable in comparison with the interest in the island destination. Moreover, in most other areas of international services, the disadvantages of remoteness

may be considerably reduced due to the increasing use of modern telecommunications.

11. The limited domestic market is a powerful incentive for establishing greater openness in the economies of island developing countries. International trade is an opportunity to fulfil needs that cannot be met by import substitution. Consequently, such heavy import dependence must be financed by a corresponding export effort to the extent that other forms of foreign-exchange transfers are insufficient. The island developing countries, however, are seriously constrained in their efforts to expand their export sector because of the low domestic technological capability and the narrow range of resources available to support the export base.

12. Given their heavy dependence on imports, small island developing countries - that have limited capabilities for the identification of appropriate sources of supply and also have limited access to information on comparative price levels for various import commodities - may have to bear heavy import bills that are already inflated by the high transport costs associated with their remoteness.

13. Another factor characteristic of the export sector of island developing countries is their specialization in a small number of export items, which is apparent in the relatively high merchandise concentration indices in many island developing countries. Specialization and extreme dependence on the external economic environment renders the economies of island developing countries extremely vulnerable. They have minimum resilience to external shocks over which they have no control. Such external shocks are reflected in wide fluctuations in production and export volumes, as well as world market price fluctuations and market restrictions.

14. An additional factor that has an adverse impact on the external sector performance of island developing countries is the burden of high international transport costs. The higher levels of transport costs for island destinations result from the low volume of individual shipments to and from islands, combined with the imbalance between the volume of merchandise imports and exports, as well as the remoteness of several island developing countries from their trading partners. Furthermore, many small island developing countries do not have the deep-water port facilities to handle bigger vessels, thus making island ports of call unattractive for long-haul shipping lines, particularly in the Indian and Pacific oceans. As a result, even inter-island trade within the same subregion is often transshipped through external hub ports, and development in containerization and bulk transport has further limited the access of large seagoing vessels to small island ports with inadequate facilities.

15. As to air transport, over the last two decades several island developing countries have devoted significant investment to upgrading airport facilities so as to accommodate wide-bodied jets, thus reducing their isolation. Such isolation, however, is still relevant in the more remote island developing countries, such as Sao Tome and Principe, the Comoros, Kiribati, Tuvalu, Niue and Tokelau, as well as in many remote islands of archipelagic island developing countries. Island developing countries have a weak bargaining position

vis-à-vis suppliers and shippers, who have the leverage to raise transportation costs.

16. Other costs of insularity result from the unreliability of transportation, which compels importers in the island developing countries to hold large stocks of a wide range of goods, including such essential goods as foodstuffs, fuel and spare parts.

17. The already precarious export economy of island developing countries is further exacerbated by their proneness to natural disasters, which continues to undermine their export capabilities. Although large-scale disasters are not confined to island developing countries, natural disasters are a particular problem, because a single disaster can result in a wide national disaster in such countries since its effects are all-pervasive and often totally devastating for agriculture, as well as tourism and other activities and infrastructure in general. In 1979, for example, hurricane David destroyed banana plantations in Dominica, where that crop is the predominant agricultural and trade activity. In the Pacific, cyclones followed by prolonged drought in 1983 and 1985 damaged sugar cane and other crops in Fiji; as a result, sugar output fell by more than 40 per cent. In 1981, smaut disease in Saint Kitts and Nevis almost completely destroyed the sugar industry, a predominant export-earning and employment-generating sector. In 1982, hurricane Isaac destroyed 90 per cent of the banana crop in Tonga. On three occasions during the 1980s, banana cultivation, citrus and coconuts were damaged in Saint Lucia, Grenada and Saint Vincent and the Grenadines. Such frequent shocks imply that in the long run, sustainable livelihoods cannot be guaranteed in economies that are as heavily dependent on the export sector as island developing countries.

18. Furthermore, the export economy in many island developing countries is indirectly threatened by the damage caused by global hazards, such as global warming and the resulting rising sealevel, which exacerbate the economic and environmental fragility of island developing countries. Furthermore, waste disposal by dumping in the ocean threatens the marine resources. The countries or areas that are most at risk are Maldives, Tuvalu, Kiribati, Tokelau, the Cocos and Keeling Islands, the Cook Islands, some islands of Tonga, and the Marshall Islands.

19. General economic development, including the growth of the export sector, is also negatively affected by the high degree of international migration. Although migration provides an important source of income generation for many small island developing countries, particularly in the form of remittances, it invariably results in the loss of the more skilled, energetic and innovative members of their population, thus delaying the technological development that is essential for the diversification of production, adaptation to changing market conditions and effective competition in world markets.

20. The rapid depletion of non-renewable resources in several small island developing countries is also a major threat to the export economies of island developing countries, particularly in countries that are heavily dependent for their export earnings on products based on such resources as are Trinidad and Tobago and Bahrain on oil; Nauru and Kiribati on phosphates; the Bahamas and Turks and Caicos Islands on argonite: Vanuatu, Fiji, the Solomon Islands and the

Dominican Republic on gold; Haiti on bauxite; Vanuatu on manganese; and Bahrain and Trinidad and Tobago on hydrocarbons.

21. Several small and remote island developing countries are also vulnerable to such illicit activities as drug trafficking. Those countries may also attract other illicit activities such as money laundering and misuses of offshore financial instruments.

22. Regional cooperation among island developing countries and with other developing countries can help them overcome the constraints of their small size. Such arrangements, which already exist in several regions, provide wider operating environments for high-level skills and a larger market for tradeable commodities and services, and thereby increase the potential for scale economies and for joint production. Such cooperation schemes also offer a wider economic space, which is conducive to a good investment climate and provides a basis for exchanges of information on various development issues among island developing countries and other countries.

23. The island developing countries, however, have a range of advantages that are often not completely perceived and exploited, such as marine resources based on large exclusive economic zones and environmental diversity and beauty that are assets for enhancing specialized tourism: such advantages constitute a potential for export growth. Sociopolitical stability in many island developing countries has also acted as a major incentive for attracting foreign investment in offshore services, and has helped, inter alia, to propel export development. A favourable political environment, combined with good policy management, has also facilitated the strengthening of economic ties with major donor countries, which have provided special trade preferences, such as the Lomé Convention and the Caribbean Basin Initiative, which have eased access to foreign markets.

II. IMPLICATIONS FOR ISLAND DEVELOPING COUNTRIES OF TRADE LIBERALIZATION AND THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS

24. In the long run, island developing countries are expected to benefit - as are other developing countries - from the global context of trade liberalization, which will bring about new trading opportunities, and from the new multilateral trade framework, which improves rules and disciplines relating to international trade. However, the extent to which island developing countries will be able to benefit from such developments will depend on their capacity to manage the transition to a situation of greater integration in the global economy. Many products made in island developing countries and exported to developed market countries enjoy preferential treatment under the Lomé Convention, the Caribbean Basin Economic Recovery Act, the Caribbean-Canadian Trade Agreement, the South Pacific Regional Trade and Economic Cooperation Agreement, and individual generalized systems and preferences granted by other countries that are members of the Organisation for Economic Cooperation and Development (OECD); trade preferences for island developing countries generally imply low-rate or zero-rate tariffs. Many island developing countries are faced with a double competitive challenge in the short run, first because of the erosion of trade preferences, and second because of the generally limited

capacity of island developing countries to meet new trading opportunities in terms of competitiveness and reliability of supply. For some island developing countries, therefore, little or no benefit is likely to be gained in the short run; a few island developing countries may actually be net losers due to losses in competitiveness and slow progress in seizing trading opportunities.

A. Changes in market access

25. The elimination of preferential access to the European Community (EC) market for coffee and cocoa beans producers of some island developing countries, such as Sao Tome and Principe, is regrettable. EC preferences for such products, as well as palm oil had helped island developing countries that incur high transport costs to reduce the comparative disadvantage thus entailed.

26. Concerning the export of bananas from island developing countries, in the light of the revised General Agreement on Tariffs and Trade (GATT), the EC import regime of preferences/tariff quotas for bananas from African, Caribbean and Pacific (ACP) countries is generally regarded as an unfair trade practice by non-ACP competing producers. Uncertainty concerning the extension of the regime beyond the official term of the Lomé Convention in 2000 makes the remaining period particularly critical for banana-producing island developing countries, which are compelled by circumstances to engage in long-term economic diversification.

27. Concerning sugar, which is of particular importance to some island developing countries, there is a risk that the intervention price of cane sugar that is offered to ACP countries by the EC might eventually decrease, even if quotas remain, as a result of the decrease in domestic support to European beet producers and the anticipated decrease in prices of beet sugar in EC countries.

28. Net food-importing island developing countries may suffer from increases in import prices of temperate products (cereals, meat) for which protection and subsidies will decrease. A ministerial decision was adopted at the end of the Uruguay Round of multilateral trade negotiations in favour of net food-importing countries. It is hoped that the compensatory measures that are expected to bring responses to the issue will be promptly implemented.

29. As a result of the Agreement on Textiles and Clothing, the gradual loss of preferences by island developing countries that export to developed countries which are called on to integrate Multifibre Arrangement (MFA) quotas into their general most-favoured-nation framework represents a major challenge for such island developing countries in view of the competition brought by third countries that will be able to export without MFA restrictions. It is important for all concerned island developing countries to take advantage of the 10-year phase-out period to adjust or reconsider their specialization in the textile sector. Adjustments should imply either significant efforts to increase competitiveness in existing textile activities or a certain amount of respecialization, either within the sector through diversification into higher value-added products or away from the sector by terminating least competitive productions.

30. For manufactured products in general, market access improvements resulting from the Uruguay Round will be beneficial to some island developing countries, particularly those that have already achieved a certain extent of diversification. For island developing countries that cannot specialize into products for which tariffs have diminished, the benefits are limited at present. However, export capacities may expand over time, with existing enterprises improving their export potential and new enterprises being created to seize new trading opportunities.

B. Agreements on non-tariff measures and new issues

31. Island developing countries whose products have been excluded by non-tariff measures will generally be better protected against unfair trade practices, since non-tariff measures will no longer be easily used as disguised forms of protection.

32. It is hoped that as a result of the Agreement on Safeguards the use of voluntary export restraints, orderly marketing arrangements and similar measures that can affect the external trade of certain island developing countries will no longer be possible. It is also expected that the de minimis clause (specifying a 3 per cent threshold in the partner country's total imports) will spare most island developing countries the threat of facing safeguard measures.

33. The Agreement on Subsidies and Countervailing Measures has complex legal and administrative implications for national implementation. Considering the supply constraints faced by many island developing countries, the use of subsidies within authorized limits should be guided by a global consideration of trading opportunities and the export potential. Many island developing countries are therefore likely to need technical assistance in implementing the Agreement.

34. The General Agreement on Trade in Services (GATS) offers a sound framework for the sector that is of great interest to island developing countries. GATS liberalizes cross-border movements of persons only at senior technical or managerial levels, which on the whole benefits island developing countries that have a prominent service sector (tourism, information processing, offshore finance etc.) and need expatriate expertise to raise such activities to international standards. It is in the interest of most island developing countries to liberalize the entry of quality services as inputs to foreign exchange-earning sectors of goods or services. Considering the importance for service economies of having access to advanced technology, island developing countries are encouraged to attach as a condition accompanying their schedules of commitments to GATS the possibility of benefiting from the assistance of developed countries in improving their access to technological facilities. An example relevant to the tourism sector is the access to computerized reservation systems, an area that is affected by article IV of GATS.

35. The Agreement on Trade-related Investment Measures (TRIMs) removes a certain degree of freedom in policy-making by prohibiting measures that are sometimes used by developing countries, including island developing countries, vis-à-vis foreign investors (local content requirements, trade balancing

requirements, minimum export requirements etc.). However, in most island developing countries, local inputs are insufficient, non-existent or unsteady. What matters more to most island developing countries is the prospect that foreign direct investment brings with regard to national employment and access to technology.

36. The Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPs) sets out a national-treatment commitment and a most-favoured-nation clause with regard to the protection of individual property. If the protection of such technology is effectively implemented, the increased cost of acquiring and using it could erode the export competitiveness of certain imitation products, particularly in the textile field, in which a number of island developing countries have been successful. At the same time, in accepting the Agreement on TRIPs there is an incentive for island developing countries to adopt appropriate technology in productive investment and pay more attention to the question of the optimum size and type of equipment, a concern that may be conducive to greater efficiency and profitability, as well as enhanced respect for the environment. Moreover, the Agreement will help island developing countries to ensure the protection of their own intellectual property rights, which will be particularly important for countries that will be diversifying into information-processing services based on locally designed software products that need appropriate protection.

37. In their consideration of the Understanding on Rules and Procedures Governing the Settlement of Disputes, island developing countries will generally benefit from the improvement brought to the new dispute settlement system, particularly because the new system is more equitable in its mediation between members with unequal bargaining powers. However, many island developing countries will be relatively unable to cope with procedural requirements, such as the various investigations and consultations implied in situations of dispute; it is therefore hoped that island developing countries that are involved in dispute settlement matters will obtain technical assistance to meet such requirements.

38. It may be in the interest of small countries in general and island developing countries in particular to facilitate the development of open economies with small numbers of efficient, larger enterprises. Governments of island developing countries should facilitate the emergence of competitive enterprises that are likely to raise quality standards while at the same time trimming price levels, which implies providing appropriate information on investment opportunities and appropriate local facilities for prospective foreign investors. Foreign direct investment and mergers or takeovers by foreign firms can bring about desirable results. Such developments, however, should be subject to competition policy if Governments want to ensure that no individual actor on the market enjoys excessive market power that would distort competition. It is therefore important to devise appropriate competition policy, adopt competition legislation and establish under such law a competition authority responsible for monitoring the implementation of the law and advising the Government on competition policy matters. The competition law should also include provisions for preventing anti-competitive mergers and acquisitions.

III. GLOBALIZATION AND THE SPECIALIZATION PROSPECTS OF ISLAND DEVELOPING COUNTRIES

39. Island developing countries should continue to aim to develop production capacities and varieties of inputs to meet the expectations of foreign partners. However, considering the difficulty of developing a carrying capacity in an island environment, many island developing countries do not expect to become fully integrated in the global economy. Such countries are often more tempted to pursue a niche market approach, since they expect the latter to offer economic opportunities of a more accessible nature.

A. Driving forces relevant to island developing countries in the context of globalization

1. Foreign direct investment

40. It is important for island developing countries to create a situation of competitive advantage in order to attract foreign investors. Factors of comparative advantage in this respect include socio-political stability and skilled human resources, the presence of a minimum diversity and quality of domestic producer services, and the existence of a reliable communications infrastructure. Another determining factor of the decision to invest is the participation of the host country in global trade and investment liberalization, particularly its commitments under the Agreement on TRIMs (unconstrained openness to investors), the Agreement on TRIPs (protection of the investor's industrial/intellectual rights) and GATS (cross-border transactions, commercial presence, personnel movements).

2. Global communications facilities

41. Gaining access to global communications facilities and information networks is very important for island developing countries, particularly for the development of trade in services: enterprises of small or medium size can thus broaden their markets by using information networks that allow them to disseminate information at a very low cost on their goods and services. Low-income island developing countries may find in electronic commerce such facilities as the cost-effective instruments for rationalizing their product specialization and enhancing their marketing possibilities offered by UNCTAD's Global Trade Point Network.

3. The new multilateral trade framework

42. The increased international competition that will result from the new multilateral trade framework will facilitate the globalization trend for all countries, including island developing countries. Virtually all island developing countries will eventually be members of the World Trade Organization (WTO), and trade liberalization should in the long run facilitate their better integration in the global economy. However, the transition to such integration is anticipated to be difficult for some countries, and will necessitate for all

island developing countries an appropriate and sustainable economic development strategy.

B. Globalization and micro-initiatives in the specialization of island developing countries

43. Some of the most disadvantaged island developing countries demonstrate little ability to diversify, or only maintain their specialization in tradeable goods or services, while others have already developed viable trading activities and are equipped to further diversify their economy in the light of new trading opportunities. For island developing countries, the issue of specialization imposes the choice between two apparently opposite approaches: (a) in the first approach, competitive activities in widely distributed goods or services imply a direct relationship with foreign economic actors who partake of the global economy; (b) in the second approach, micro-initiatives will involve island-specific goods or services with a unique nature, and will generally have a trade relationship with very few partners (the niche market approach). There are merits in both approaches, which are not incompatible and can reinforce each other and create a pattern of sustainable economic development.

1. Globally induced specialization

44. Conditions for successful specialization in globally related activities include an adequate physical infrastructure, in particular for international transport; the existence of a sufficient base of producer and professional services; a climate of socio-political stability; and sufficient openness to foreign investors in the trade-related investment regime. Such factors are actually more important for attracting foreign direct investors than labour cost competitiveness and investment incentives.

2. Niche-type specialization

45. Niche market activities are generally micro-development experiences based on small-scale projects that involve small inputs, small outputs and generally small market outlets. The niche market approach is apparently opposite to the globally induced approach to specialization, mainly because of differences in the numbers of economic actors involved and the size of markets (global as opposed to captive). However, the two approaches can be interrelated and complementary. There are many cases of island economic activities that stand close to one of the two models, while actually drawing on both in a viable manner. In many island developing countries, the two opposite approaches can be reconciled because they can reinforce each other. In particular, success vis-à-vis global competition may take place in island economies that have been able to create, despite handicaps, an enabling domestic environment (infrastructure, skilled human resources, producer services etc.) that can in turn enhance the chances of success of niche market activities, which often derive from initiatives that draw on competitive experience.

C. General remarks related to sectoral specialization

46. Viable respecialization often implies initial diversification within the commodity sector, followed by specialization in other activities.

47. There is a significant scope for viable specialization or respecialization for island developing countries through the development of international services, a field of activities that is being encouraged by the new WTO framework and in which there is space for initiatives to help island economies to find a path to economic sustainability. A large proportion of the encouraging scope for services lies in specialized tourism, offshore finance, information processing and a variety of micro-activities based on island-specific features and advantages.

48. Overall, successful specialization or respecialization implies the adoption of a development strategy that will adequately address the specific problems of island developing countries, will recognize and exploit all possible comparative advantages, and will take into consideration the aim of environmentally sustainable development.

IV. POLICY RECOMMENDATIONS

A. The new approach to island-specific characteristics

49. Particular attention should be given to the evidence of an increasingly broader variety of socio-economic situations among island developing countries. As a result, the relationship between island-specific handicaps related to their small size and remoteness, on the one hand, and their economic performance, on the other hand, has become less straightforward than in the past. Some small island economies that used to be regarded as acutely disadvantaged have actually demonstrated significant growth over time and are now classified among high-income countries, while some of the larger and less remote among them are facing severe challenges in the context of trade liberalization and globalization. In short, the nature of economic issues among island developing countries has evolved, even though the disadvantages of "islandness" remain real in many of them. This evolution of issues implies an evolution in the analysis towards policy responses.

50. In future analytical work, categorization of island developing countries by type of specialization, performance or vulnerability should be systematic. This is necessary if one is to enhance awareness of the relationship between their socio-economic performance and its underlying factors. Consideration of homogeneous sub-groups of those countries seems to be the avenue to effective cross-country analysis regarding them. There are still common characteristics and problems among island developing countries, but these characteristics and problems are more usefully dealt with within sub-groups and through comparisons between sub-groups. By studying island developing countries along these lines, one can draw lessons from the successes or failures of some island developing countries with a view to helping other such countries to achieve progress towards sustainable economic development.

B. Sustainable economic development strategy

51. The main challenge facing island developing countries is to adopt an overall development strategy that is designed to reduce the vulnerability of their economies and facilitate sustainable economic development. Such a strategy will have to be outward-oriented because trade in goods and services, international capital flows and international migration will continue to play an important role in the development patterns of these countries. Some flexibility should, however, also be encouraged to reduce the heavy dependence on imports by striving to create more integrated production structures based on available domestic resources in such areas as food and artisanal fisheries so as to build up and maintain a nutritional "safety net".

52. The development strategy of island developing countries should furthermore establish a framework for macroeconomic policies and reforms that respond effectively to longer-term requirements for sustainable development in various sectors of the economy. The role of the private sector in formulating and implementing such a strategy should be vigorously enhanced. Such a framework would develop or strengthen processes to assess the environmental effect of trade policies, enhance coordination between environmental and trade policies, including cooperation between environmental and trade officials in the policy development process and promote transparency and openness to the public in these processes.

C. Alleviating intrinsic handicaps of island developing countries

53. In an increasingly competitive world, the island developing countries are at a serious disadvantage because of the intrinsic weaknesses of their economies, which is a result of the range of adverse factors that have been discussed above. The island developing countries should therefore with the support of the international community give high priority to the following policy actions.

Human and institutional development

54. The human resources and institutional infrastructure development programmes should be enhanced. Special attention should be given to the development of adequate statistical databases and specialized software packages and to incentives to attracting skilled returning migrants. There is a need for special programmes of "education for sustainable development" that put special emphasis on changes in attitudes and values and on cultivating an island-specific culture that is responsive to new socio-economic challenges.

55. In view of the growing need for skilful negotiations on the part of island developing countries in international forums and with foreign investors, special training programmes should be organized with the support of the international community to overcome these particular constraints.

56. Efforts must be made to promote actively indigenous entrepreneurs. Returning migrants with entrepreneurial skills and capital should be provided with the appropriate environment to make a contribution in this area.

57. Measures to enhance socio-political stability, good governance and sound macroeconomic policies that are conducive to private foreign and domestic investment should be strongly encouraged.

Technology transfers

58. Island developing countries should identify appropriate technologies to encourage an environment-friendly diversification of production and trade and help to adapt to changing market conditions and compete internationally.

Natural resources

59. They should seek to fully exploit, within the framework of sustainability, their agricultural potentials and marine resources in the exclusive economic zones through enhancing the relevant skills and carrying out specialized studies on the conservation, management and surveillance of the above resources. Appropriate marketing structures and decentralized and affordable credit facilities should be encouraged.

Services

60. The service sector, particularly tourism and offshore services, should be encouraged. In developing tourism, efforts should be made to encourage forward and backward linkages in other sectors of the economy. Proper management of environmental assets, which is essential for the sustainability of tourism, should be promoted. Environmental considerations should be taken into account in tourism development by encouraging new types of tourism such as eco-tourism and cultural tourism that are based on or associated with environmental assets, and therefore imply environmental protection.

Transport and communications

61. Innovative approaches to transport and communications development that facilitate low-cost access to such services, particularly for the small remote island developing countries and archipelagic countries should be promoted. Projects to improve not only links with the main trading partners but also inter-island feeder services should receive special donor attention because many of them do not meet the normal commercial criteria. International assistance will be required for island developing countries to improve their information infrastructure and enhance their trade opportunities through the use of telematic facilities such as Internet.

Global hazards

62. National regulations should be put in place to counter illicit uses of offshore financial instruments, and measures to prevent drug trafficking should be enhanced through regional and international cooperative arrangements.

63. Disaster preparedness and warning capabilities should be enhanced, and measures to mitigate the effects of disasters should be integrated into long-term trade policies and planning.

64. Measures to mitigate the consequences of global warming and sealevel rise should be a central part of environmental planning.

Efficiency of import regimes

65. The small and remote island developing countries, with their heavy dependence on imports, need to be supported to identify ways of reducing the costs of their imports. This may include, inter alia, better access to competitive sources of supplies, streamlining of import procedures, the establishment of databases on international prices and quality of import products. Such countries should also undertake measures to discourage imports of certain products which pose a threat to their fragile environment.

D. Liberalization, globalization and sustainable development

66. Sustainable economic development in island developing countries largely rests on specialization in sectors that are not only viable economically, but also non-polluting (environment-neutral/friendly) or based on environmental assets (for example, eco-tourism). The question of specialization in the pursuit of sustainable economic development is of particular importance. The implications for specialization of trade liberalization and globalization should be further analysed, with a view to maximizing the benefits of new trading opportunities.

E. Enhancing the use of current trading opportunities

67. The capacity of island developing countries to better exploit existing trade preferences should be strengthened. In spite of the erosion of preferential margins, generalized systems of preferences (GSP) are expected to continue to play a significant role in facilitating the participation of island developing countries in international trade. Rules of origin criteria should be flexibly defined for the most poorly endowed countries. Preference-giving countries should be encouraged to accept relatively higher proportions of third-country inputs in the manufacturing of export goods and provide for simple administration of documentary and shipment requirements. Other measures to enhance the effectiveness of GSP schemes should include the extension of product coverage to more goods of export interest to island developing countries (e.g., tropical products, leather goods, textiles and clothing) and the harmonization of GSP rules of origin among preference-giving countries.

F. Taking advantage of new trading opportunities

68. Island developing countries should make an effort to analyse their specialization pattern, identify new trading opportunities in goods and services, and devise national policies for envisaged diversification. Such

support could involve detailed national studies, for those countries seeking an enhanced specialization, of their current specialization (factors, structure, etc.), re-specialization potential, and new trading opportunities with respect to goods or services (including for "niche" markets) in the regional and international trading environment. National policies could then be recommended to warrant successful diversification in these countries.

69. Developing the capacity of island developing countries to identify new trading opportunities is essential for these countries. This could be achieved through systematic analysis, at the national level, of the implications of changes in market access for island exports, considering the existing patterns of trade and the potential for diversification. The development of trade information capacities through global communications facilities should be actively pursued in this connection. Generally, more technical assistance will need to be devoted to the identification of new trading opportunities and dissemination of findings.

70. Awareness of the new rights and obligations of island developing countries which are or will be members of WTO is also essential, and will imply continued technical assistance to facilitate the implementation of market access commitments and enable them to implement legislative and regulatory changes with regard to non-tariff policies and new issues (TRIMs and TRIPs, in particular).

G. Promoting a favourable environment to enhance specialization

71. In order to enhance their specialization or, whenever necessary, "re-specialize", island developing countries need to create an "enabling" environment for investment, diversification and trade expansion. A useful input, to that end, would be the preparation of a policy paper on the areas of action to take into consideration to enhance the specialization of such a country (investment, technology, trade, human resource development). Detailed policy recommendations could then be provided to individual island developing countries on investment, technology and the "enabling" economic infrastructure for trade development, including domestic support services; and on trade, including the adaptation of national trade policies to the new multilateral trade framework. Human resources for investment attraction, technological development and trade expansion should also be enhanced in the perspective of re-specialization in individual island developing countries.

H. Developing sectoral information

72. Action should be taken to raise the level of awareness of opportunities for enhanced specialization in goods or services that are of special interest to island developing countries, with particular emphasis on the conditions for success and expected benefits. This could involve developing a database on sectoral specialization in those countries; establishing an inventory of sectoral activities and related trading opportunities of potential interest to island developing countries that seek to enhance their specialization; and carrying out special in-depth studies of selected sectors of goods and services

for enhanced specialization in those countries, with particular focus on conditions for success and anticipated benefits.

I. Regional and international support measures

73. The donor community is called upon to provide to the island developing countries the required financial and technical assistance in support of their domestic efforts in all the critical areas that have been elaborated on above. Given the particularly acute resource constraints and the volatility of export earnings of most island developing countries, international assistance should continue to be provided on highly concessional terms and over a long time-frame. Other terms and conditions of such assistance including the procedures for aid delivery should be flexible and simplified in order to respond to the vulnerability of these countries.

74. In view of the small size constraint on many island developing countries, special efforts should be made to promote regional cooperation arrangements which offer a viable framework for achieving economies of scale in various economic activities, particularly with regard to resource exploitation, protection and policing of coastlines and exclusive economic zones, environmental protection, trade, development and sharing of human resources, expansion of inter-island feeder services, tourism development and exchange of information on successes and failures in various areas of development.

75. Subregional, regional and international organizations involved in trade-related issues should stand ready to provide the required technical assistance designed to strengthen the efficiency of the external sectors of the island developing countries, including assistance in enhancing their capabilities to negotiate in international forums and with foreign partners such as private investors. The role of the Alliance of Small Island States (AOSIS) in this regard should be further strengthened and similar initiatives by other institutions should be encouraged.

J. The role of UNCTAD

76. UNCTAD, in its field of competence and in collaboration with the relevant regional and international organizations, should be prepared to extend to them a technical cooperation capacity in respect of policies for sustainable economic development. A technical cooperation project in favour of island developing countries should be developed along these lines and provide, inter alia, for analysing the scope for those countries for enhancing their international competitiveness and specialization in certain new sectors of goods or services of particular interest to these countries. UNCTAD should carry out specialization strategy studies at the national level to assist such countries in exploiting new trading opportunities and enhancing their specialization. The areas to be covered relate, inter alia, to investment, trade, technology and human resource development.

77. It is recommended that a second meeting of island developing countries and donor countries, similar to the one convened in 1990 pursuant to General Assembly resolution 43/189 be organized by UNCTAD by mid-1997 to assess, inter alia, the progress in the implementation of the recommendations of this panel, including the review of the activities carried out within the framework of the technical cooperation project mentioned above.